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Financial Market Review

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The world recently witnessed a number of jubilant celebrations as the year, century, and millennium came to a close, but investors in the US stock market were the giddiest of all. Inspired by restrained inflation, robust growth in corporate profits, and a love affair with technology stocks, equities soared at year-end to finish at new highs on both the Dow Jones Industrial Average and the Standard & Poor's 500. Not only did these indexes register their fifth consecutive year of double digit returns, but the technology-laden NASDAQ Composite Index recorded an astounding return of 85.6% in 1999 with more than half its advance occurring during the final two months of the year.

The market achieved its gains despite the potentially significant obstacle of a sharp increase in interest rates. It also overlooked such factors as rising oil prices, tight labor markets, and unexpected volatility in some major currencies.

While the 17-year bull market in stocks continued, there remained a major bifurcation between the haves and have-nots. The market was led by the technology-oriented "new economy" stocks, some of which rose more than ten times in value over the year, but there were many "old economy" stocks that suffered major declines. The list of significant losers was led by Philip Morris (down 57%) and included Xerox, Pfizer, Coca Cola, Merck, and Gillette. Symbolizing the year's trends, even legendary investor Warren Buffett's Berkshire Hathaway Corporation declined for the year as its portfolio avoided participation in technology stocks.

Were it not for its technology sector, which comprises more than 25% of the index and rose about 80% over 1999, the S&P 500 would have been down about 1% for the year. On both the S&P 500 and the Russell 2000 (small stock) indexes, declining stocks exceeded winners by about a 55%-45% ratio for the year. On the New York Stock Exchange, the ratio in favor of declining stocks was 60%/40%. Even on the NASDAQ, the startling overall gain masked the fact that the advancing stocks only slightly exceeded the losers.

Valuations in the equity market rose even further from their record highs as the Price/Earnings Ratio on the S&P 500 was estimated to have increased from 32.3 to 33.4. These measures are skewed by the particularly high valuations attached to many technology stocks. Reflecting the fact that many of these high-flying stocks have little or no earnings to date, the estimated year-end Price/Earnings Ratio on the NASDAQ was an astounding 200!

After several years of frustration, small-cap stocks staged an impressive comeback as the Russell 2000 modestly outperformed the S&P 500. However, value stocks remained in the doldrums as they were once again

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trounced by growth stocks. The 12-month performance differential in favor of growth stocks was over 15% in the S&P 500 and was even greater for the mid-cap and small-cap universes. The continued dominance of growth stocks reflects the market's obsession with technology stocks, where future prospects and expectations far outweigh current profitability in investors' minds.

Unlike the previous four years during which the US market dominated global markets, 1999 saw many world markets outperform the US. The Morgan Stanley EAFE Index outgained the S&P 500 by about 6% for the year. Asian/Pacific markets did particularly well, with Japan's market (up 67% in dollar terms) staging a dramatic comeback from its decade-long slumber. European markets offered more modest returns as economic growth was generally disappointing and returns to US investors were further impacted by an unexpectedly weak euro. Emerging markets recovered strongly from 1998's crisis as the Morgan Stanley Emerging Markets Index spurted 66% for the year. Not surprisingly, the best performing global stocks were also generally technology and telecommunications companies.

In sharp contrast to the exuberance of equity investors at year-end was the sheer despair of long-suffering bond investors who endured their worst year since 1994 and the second worst since 1973. The Federal Reserve tightened three times, taking back the easings that occurred in reponse to the 1998 liquidity crisis. As the economy showed no signs of cooling off at year-end, the market ended on a very weak tone as investors feared that the Fed would have to tighten further in the new year in order to dampen inflationary expectations. Over the year, the bellweather 30-year Treasury bond rose in yield from 5.10% to 6.48%, the highest level in over two years. Holders of that bond suffered a total return of –14.8%, while holders of shorter maturity and "spread product" bonds did better. High-yield corporate bonds, mortgage-backed bonds, and asset-backed bonds actually recorded modestly positive returns. Using conventional valuation measures, bonds could be considered fairly attractive relative to stocks at year-end but there was little to indicate that the investing tide might be turning back in their favor.

Real estate investors had varied returns depending on their vehicle of investment. Privately-held property generally enjoyed healthy appreciation as economic conditions were favorable in every region of the country and most segments of real estate were considered to have a healthy balance between supply and demand. However, publicly-traded Real Estate Investment Trusts suffered their second consecutive year of negative total return. Many—including Warren Buffett—considered REITs to offer attractive intrinsic value relative to underlying property values, but the sector remained very much out-of-favor with equity-focused investors.

While bonds were downright gloomy and real estate had a split personality in 1999, the asset class of alternative investments—particularly venture capital—was red hot. With record sums being raised for start-ups and very generous valuations awarded to "dot.com" initial public offerings without regard to near-term profitability, the year saw a slew of experienced executives leave traditional businesses to join internet startups or venture capital management firms. Returns in these markets generally lag by a quarter, but through September 30, 1999, returns on venture capital (both early stage and later stages) were 62.5% for the trailing twelve months and 28.7% for overall private equity (including buyouts and mezzanine financing) as reported by Venture Economics.

As the 21st century dawned, there were some fundamental questions that investors were asking themselves after another year of historically generous equity gains. Are we indeed in an historical era of technological innovation in which all the traditional rules of investing are being rewritten, or are we experiencing an investment mania that will end badly? Will companies with no earnings continue to command far greater valuation multiples than established, profitable concerns? Is it foolish to hold equities at today's nosebleed valuations, or is it more foolish to be on the sidelines uninvested? Are historical relationships between economic growth and inflation, and between stocks and bonds, no longer valid? What effect will this year's national election have on the investment landscape? Finally, will the Red Sox win the World Series in this century? ◆

PLEASE NOTE:
The PERAC Investment Unit welcomes any comments you may have on this report & encourages all boards to contact us at any time for assistance relating to investment activities. Extra copies of this report are available.

Fourth Quarter 1999 Total Returns

INDEX	FOURTH QUARTER RETURN	FULL YEAR 1999
U.S. Equity Market		
DOW JONES INDUSTRIAL AVG.	11.62%	27.20%
STANDARD & POOR'S 500	14.88%	21.04%
NASDAQ COMPOSITE	48.18%	85.60%
WILSHIRE 5000	18.52%	23.82%
RUSSELL MIDCAP	17.23%	18.23%
RUSSELL 2000	18.44%	21.26%
Growth vs. Value		
S&P 500 GROWTH	19.74%	28.25%
S&P 500 VALUE	8.97%	12.72%
RUSELL MIDCAP GROWTH	39.47%	51.29%
RUSSELL MIDCAP VALUE	3.77%	– 0.11%
RUSSELL 2000 GROWTH	33.39%	43.09%
RUSSELL 2000 VALUE	1.53%	– 1.49%
Global Equity Markets		
M.S.C.I. - E.A.F.E.	17.0%	26.96%
M.S.C.I. - EMERGING MARKETS	24.67%	66.18%
Fixed Income		
LEHMAN BROTHERS AGGREGATE INDEX	– 0.1%	– 0.8%
LEHMAN BROTHERS CORPORATE INDEX	0.0%	– 1.9%
LEHMAN BROTHERS GOVERNMENT INDEX	– 0.6%	– 2.2%
LEHMAN BROTHERS MORTGAGE INDEX	3.4%	1.9%
FIRST BOSTON HIGH-YIELD INDEX	2.1%	3.3%
Real Estate		
NAREIT - EQUITY REAL ESTATE INVESTMENT TRUSTS	– 1.01%	– 4.62%
NCREIF PROPERTY INDEX	NA	8.02% thru Q3

Glossary

DOW JONES INDUSTRIAL AVERAGE: A price-weighted index tracking thirty large industrial companies selected by the editors of *The Wall Street Journal.*

STANDARD & POOR'S 500 INDEX: A broad-based market index, weighted by market capitalization, that comprises about 75% of the total market value of publicly traded US equities.

NASDAQ: The National Association of Securities Dealers Automated Quotation System is an over-the-counter trading exchange used mainly by newer, technology-oriented companies.

RUSSELL 2000: The major index that tracks small capitalization stocks.

LARGE CAPITALIZATION STOCK: Total market value of outstanding stock exceeds $5 billion.

MID-CAP STOCK: Between $1.5-5 billion in market capitalization.

SMALL-CAP STOCK: Less than $1.5 billion market value of stock outstanding.

GROWTH STOCK: Stock of companies that, due to their strong earnings potential, offer above-average prospects for capital appreciation, with less emphasis on dividend income.

VALUE STOCK: Stocks that, considering a company's assets and earnings history, are attractively priced relative to current market standards of price-to-earnings ratios, price-to-book ratios, et al. They typically pay regular dividends to shareholders.

PRICE/EARNINGS RATIO: Sometimes referred to as the "multiple", the P/E Ratio is the stock price divided by the company's net income per share over the past twelve months.

TREASURY YIELD: The current market interest rate on bonds issued by the US Treasury with a specific maturity date (i.e. 30 years). Bonds are issued at a specific interest rate and at a specific price (such as 100 or "par") but the subsequent price and yield will be determined every day by prevailing market conditions. If rates generally rise (fall) after initial issuance, the price of the original bond will fall (rise) in order to make the effective yield on the bond rise (fall) to a level consistent with those on currently issued securities.

CORPORATE BOND SPREAD: The "spread" is the incremental yield offered by corporate bond issuers over those of US Treasury securities of similar maturity. The spread is a measure of investors' willingness to assume the extra credit risk inherent in corporate securities compared to virtually riskless US Treasuries.

FEDERAL FUNDS RATE: The rate at which reserve funds ($1 million or more) are traded among commercial banks on an overnight basis.

HIGH-YIELD ("JUNK") BONDS: Bonds rated below investment grade issued by corporations whose overall business or financial condition is relatively weak or risky. These bonds react less to general interest rate trends than do investment grade securities.